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IN THE

Supreme Court of the United States

OCTOBER TERM, A. D. 1930.

No. 90.

FRANK L. SMITH, CICERO J. LINDLY, HAL W. TROVILLION, P. H. MOYNIHAN, WILLIAM BURKHARDT, EDWARD H. WRIGHT and WILLIAM J. SMITH, the persons constituting the Illinois Commerce Commission of the State of Illinois, and OSCAR E. CARLSTROM, Attorney General of the State of Illinois,

Appellants,

AND

CITY OF CHICAGO, a Municipal Corporation, **Intervenor,**
Appellant,

vs.

ILLINOIS BELL TELEPHONE COMPANY,
Appellee.

BRIEF AND ARGUMENT FOR APPELLEE

APPEAL FROM DISTRICT COURT OF THE UNITED STATES, FOR THE NORTHERN DISTRICT OF ILLINOIS, EASTERN DIVISION (3746).

CHARLES M. BRACELEN,
HORACE KENT TENNEY,
WILLIAM DEAN BANGS,
Solicitors for Illinois Bell Telephone Company.

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Northwestern Bell Telephone Company v. Spillman, 6 Fed. (2) 663 7,24

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PRIOR OPINIONS IN PRESENT CASE.

On Temporary Injunction:

Frank L. Smith, et al. v. Illinois Bell Telephone Company, 269 U. S. 531. (United States Supreme Court, October 19, 1925.)

On Motion for Judgment on Pleadings:

Illinois Bell Telephone Co. v. Frank L. Smith, et al., 39 Fed. (2) 157. (District Court, N. D. Illinois, Eastern Division, July 1, 1927.)

On Final Hearing:

Illinois Bell Telephone Company v. Moynihan, et al., 38 Fed. (2) 77. (District Court, N. D. Illinois, Eastern Division, January 31, 1930.)

Supreme Court of the United States

OCTOBER TERM, A. D. 1930.

No. 90.

FRANK L. SMITH, *et al.*, ***Appellants,***

AND

CITY OF CHICAGO, a Municipal Corporation, **Intervenor,** ***Appellant,***

vs.

ILLINOIS BELL TELEPHONE COMPANY, ***Appellee.***

BRIEF AND ARGUMENT FOR APPELLEE

STATEMENT OF FACTS.

On appeal from the temporary injunction granted by the Statutory Court December 21, 1923 (without any opinion), this Court affirmed the order in a memorandum opinion October 19, 1925 (*Frank L. Smith* v. *Illinois Bell Telephone Co.*, 269 U. S. 531). In the following year the Company filed with the Statutory Court a motion for a permanent injunction on the pleadings (R. Vol. I., p. 171), which was denied (*Illinois Bell Telephone Co.* v. *Frank L. Smith*, 39 Fed. (2) 157; R. Vol. I., p. 173).

After final hearing the Statutory Court filed its opinion (38 Fed. (2) 77; R. Vol. I., p. 178). The Company moved the Statutory Court to enter findings of fact (R. Vol. I., p. 200), which was denied on the ground that the Statutory Court had filed an opinion embodying the findings of fact (R. Vol. I., p. 202).

The facts so found material to the issues now presented are as follows:

1—The American Telephone and Telegraph Company, which owns the majority of the stock of the Illinois Bell Telephone Company, has not dominated and controlled the officers and directors of the Illinois Company, and the Illinois Company is not a mere agency or instrumentality of the American Company.

2—The Illinois Company is the proper party plaintiff.

3—The order of the Illinois Commerce Commission as to the payments made to the American Company by the Illinois Company under its License Contract is followed by the Court, but without the Court's approval of the Commission's deduction of the amount of $360,000 from the total annual payment of $1,724,254.

4—The evidence did not show an abuse of discretion by the directors of the Illinois Company in entering into the supply contract with the Western Electric Company, Inc. (The American Company owns a majority of the common stock of the Western Electric Company.)

5—The method used by the Illinois Company in separating its interstate property was reasonable and is approved.

6—The evidence does not disclose any abuse of discretion or fraud in connection with the division of interstate tolls between the American Company and the Illinois Company, and the method of division is approved.

7—The reproduction cost new of the physical property

of plaintiff used and useful in rendering telephone service in Chicago as of June 30, 1923 (excluding working capital, and not including going value) was at least $145,000,000.

8—The original cost of said physical property (excluding working capital, and not including going value, but including $5,000,000 for undistributed construction costs or overheads) as of the same date, was $101,600,000.

9—The reproduction cost new less depreciation of said physical property (excluding working capital of $3,000,000 as found, and not including going value, which the Court stated to be at least $4,200,000), as of the same date was at least $130,500,000.

10—Finding Number 8 of the Illinois Commerce Commission, excluding from the valuation extensions and additions to the amount of $26,000,000 paid for from the depreciation reserve of the Illinois Company, was an error of law.

11—The fair value of all property of plaintiff used and useful in rendering telephone service in Chicago on said date was at least $125,000,000 (after deducting 10 per cent for depreciation).

12—The rates prescribed by said Illinois Commerce Commission in its order of August 16, 1923, involving an annual reduction of $1,700,000, would not, if made effective then or at any time thereafter, have paid the plaintiff's necessary operating expenses and left available for return a fair return upon the fair value of plaintiff's property used and useful in rendering telephone service in its Chicago exchange.

Plaintiff's statement of revenue and expenses for the year 1923 was found to be substantially correct, with the exception of the portion of the payment under the License Contract above referred to, and the depreciation expense,

as to which latter item there was no finding. The Statutory Court stated that it had not undertaken to decide disputed questions where it was apparent that, in the view most favorable to the defendants, the return to the Company would still be inadequate. This holding of the Court was based upon the following calculations:

Amount available for return in 1923 under existing rates	$6,280,000
Add disputed payment under the License Contract	360,000
Add disputed expense of depreciation	1,800,000
Assumed total return	$8,440,000
Less reduction in rates established by enjoined order of Commission	1,700,000
Assumed net return	$6,740,000

Minimum valuation, $125,000,000 (after deducting 10 per cent for existing depreciation), on which the assumed return is less than 5½ per cent.

If the minimum valuation be reduced to $113,500,000 by the deduction of the depreciation reserve of $26,000,000, the Court stated that the deduction of $1,800,000 from the annual expense of depreciation cannot be allowed, so the Company's return becomes only $4,940,000, *i. e.*:

Amount available for return	$6,280,000
Add disputed License Contract payment	360,000
	$6,640,000
Less reduction in rates	1,700,000
Assumed return	$4,940,000

which is less than 4½ per cent on the assumed minimum valuation of $113,500,000. Moreover, the Court stated (as the record demonstrated, Company's Exhibit 4, R. Vol. IV., p. 1193), that its finding of confiscation on this premise in 1923 applies with increasing force to the succeeding years.

If a comparison is desired of the findings made by the Illinois Commerce Commission in the enjoined order, such findings are quoted in the opinion of the Statutory Court (R. Vol. I., pp. 191-192), taken from the Commission's order (R. Vol. I., pp. 43-45).

Since the issues before this Court involve an examination of the opinion and findings of the Statutory Court and the evidence in support thereof, we will present the questions in the order of the findings as above stated.

SUMMARY OF ARGUMENT

Page of Argument

I.

The relationship between the American Company and the Illinois Company based on the former's ownership of stock in the latter, and the effect of that relationship upon questions in this case. 10-18

The Illinois Company and the American Company are distinct corporate entities. This separate corporate existence makes the Illinois Company the proper party plaintiff, and its separate existence and management cannot be disregarded. 18-23

A.

By the concurring judgment of the three judges composing the Statutory Court which heard this case below, it was found as a fact, after "careful scrutiny" of all the evidence relating to the relationship between these two Companies, that the American Company had not dominated or controlled the officers and directors of the Illinois Company; that there was co-ordination of activities between the Companies to produce efficient unified service; and that there was nothing in the evidence justifying a departure from the rule established by this Court as to transactions between the American Company and a local company whose stock it thus owns (R. Vol. I., p. 182).

Upon this finding, and the facts involved in it, no question of law as to the relationship between these Companies is presented **which has not already been decided by this Court** and by the lower Federal Courts, and in all instances

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applied to the relations between the American Company and to transactions between it and Associated Companies.

Houston v. *Southwestern Bell Telephone Co.*, 259 U. S. 318, 323. 27

Missouri, ex rel., Southwestern Bell Telephone Co. v. *Public Service Commission*, 262 U. S. 276, 288-289. 27

Northwestern Bell Telephone Company v. *Spillman*, 6 Fed. (2) 663 (District Court, D. Nebraska, Lincoln Division.)

Pacific Telephone & Telegraph Company v. *Whitcomb*, 12 Fed. (2) 279, 284-285 (District Court, W. D. Washington, S. D.)

Chesapeake & Potomac Telephone Company v. *Whitman*, 3 Fed. (2) 938, 957 (District Court, D. Maryland.)

Indiana Bell Telephone Company v. *Public Service Commission*, 300 Fed. 190, 204 (District Court, D. Indiana.)

In other cases involving this proposition, this Court has held that the *fact* of separate corporate existence cannot be disregarded and the *fiction* of corporate identity substituted in its place; also, that the relation of controlling stock ownership does not destroy the separate corporate identities, nor raise a presumption that control over the company whose stock is thus owned, or over the action of its officers, results from such ownership.

Pullman's Palace Car Company v. *Missouri Pacific Company*, 115 U. S. 587, 596. 19

Peterson v. *Chicago, Rock Island & Pacific Ry. Co.*, 205 U. S. 364, 391. 19

Porter v. *Pittsburgh Bessemer Steel Company*, 120 U. S. 649, 670.

Cannon Mfg. Co. v. *Cudahy*, 267 U. S. 333, 335.

United Fuel Gas Co. v. *Railroad Commission*, 278 U. S. 300, 320-321.

In order to justify the disregard of the separate existence of corporations thus related by stock ownership, and to treat the company whose stock is owned as a mere agent, it is essential that the stockholding company must in fact interfere in the regular affairs of the other company, and direct its actions as if they were its own; and this situation must be brought about by the united intention of both companies.

Kingston Dry Dock Co. v. *Lake Champlain Transportation Co.*, 31 Fed. (2) 265, decided in 1929.

No such condition is shown to exist in this case; no such interference or control has ever been exercised by the American Company, nor contemplated by the officers of either Company.

B.

The Statutory Court stated that the appellants presented to it as the basis of their theory—deduced from assertions which the Court found to be untrue—that:

(a) The real party plaintiff, and the real operator of the property of the Illinois Company, is the American Company; or,

(b) The inquiry as to confiscation of property, and the proper rate of return, involves the question of confiscation of the property of the American Company, and the rate of return to the investors of that Company, disregarding in this inquiry the corporate identity of the Illinois Company.

This proposition is not consistent, either with reason or with the rule settled by controlling decisions, and is impossible of application.

The American Company was not a party before the Commission or the Court.

The Illinois Company is undeniably the owner and operator of the property whose rates are involved, and at which the action of the Commission was directed.

Page of Argument

The Illinois Commission, in the enjoined order, did not find any such fact or condition as is thus stated in appellants' proposition, or find that the American Company had exercised any domination over the officers of the Illinois Company. It merely assumed that, because of this stock ownership, contracts between the Companies could not be regarded as "made between separate parties".

This assumption of the Commission is exactly contrary to the rule with reference to this very relationship established by the decisions in Illinois, under whose laws both the Commission and the corporation were organized, and of the Federal Courts.

State Public Utilities Commission, ex rel., Springfield v. *Springfield Gas & Electric Company*, 291 Ill. 209, 234. Quoted with approval in *Southwestern Bell Telephone Co.* v. *Public Service Commission*, 262 U. S. 276.

Public Utilities Commission v. *Romberg*, 275 Ill. 432, 447. 20, 25

The assumption is also inconsistent with the Commission's prior action, for it authorized each increase of the stock of the Illinois Company, which was afterward purchased by the American Company; and also authorized the sale of the stock to, and the purchase by, the American Company (see Company's Exhibits 49-A to 49-J, inclusive, R. Vol. IV., pp. 1530-1547). The relationship between these Companies thus established by stock ownership has received the Commission's repeated official approval.

C.

The cases relied upon by appellants on this question are not in point. We indicate in our argument some of the features which distinguish them from the case at bar. 20-23

U. S. v. *Lehigh Valley R. R. Co.*, 220 U. S. 257. 20

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C., M. & St. P. Ry. Co. v. *Minneapolis Civic & Commerce Ass'n*, 247 U. S. 490. 20

People of the State of Michigan, ex rel., Attorney General v. *Michigan Bell Telephone Co.*, 246 Mich. 198; 224 N. W. 438, June 20, 1929. 21-2

Chesapeake & Potomac Telephone Co. v. *Whitman*, 3 Fed. (2) 938, 957. 22

United Fuel Gas Co. v. *Railroad Commission*, 278 U. S. 300. 25

D.

The finding of the Statutory Court that the American Company did not in fact exercise any control over the officials of the Illinois Company is sustained by the evidence. 28-3

E.

The efforts of the Bell System to secure universal telephone service by a general policy with reference to matters which affect the service of all companies do not sustain the appellants' contentions. 31-3

F.

The annual reports issued by the American Company cannot be treated as statements made by the Illinois Company, and are not admissible against it. 32-3

And in any view they do not sustain the theory of appellants' case on this question.

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II.

There was no abuse of discretion by the directors and officers of the Illinois Company with regard to the License Contract with the American Company. 35-39

The record shows that the services rendered to the Illinois Company under this contract were necessary to the conduct of its business, the compensation paid therefor was reasonable, and the value of the services was greatly in excess of their cost.

Court and Commission decisions approving the License Contract are listed in Appendix A (*post*, p. 61).

III.

The advantages to the Illinois Company of its general supply contract with the Western Electric Company, Inc., are shown by the evidence, which conclusively supports the finding of the Statutory Court approving the contract. 39

See cases collected in Appendix B (*post*, p. 65), approving the general supply contract.

IV.

Approval of the method of separation of the interstate property of the Company by the Statutory Court is sustained by the evidence, and the decisions of Courts and Commissions thereon. 40-44

Pacific Telephone & Telegraph Co. v. *Whitcomb*, 12 Fed. (2) 279.

New York Telephone Co. v. *Prendergast*, 300 Fed. 822, 827.

State, ex rel., Hopkins v. *Southwestern Bell Telephone Co.*, 223 Pac. 771.

The cases decided by State Commissions approving the basis of separation used by the Illinois Company are listed in Appendix C.

The question is one of management in selecting units of service.

Chicago, Milwaukee and St. Paul Ry. Co. v. *State of Wisconsin*, 238 U. S. 491.

No affirmative evidence of any other method of separation was offered by appellants, and the reasonable method used by the Company must be approved.

Rowland v. *St. Louis & San Francisco R. R. Co.*, 244 U. S. 106, 108.

Groesbeck v. *Duluth, S. S. & A. Ry. Co.*, 250 U. S. 607, 614.

No conflict exists between the method of partial separation approved by this Court in *City of Houston* v. *Southwestern Bell Telephone Company*, 259 U. S. 318, and the complete interstate separation presented in the present record.

V.

The finding of the Statutory Court that the division of interstate tolls between the Illinois Company and the American Company was reasonable is sustained by the evidence.

VI.

Reproduction cost new.

The Commission and the Statutory Court were in substantial agreement in their findings, after correcting the error in the Commission's finding.

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VII.

Original cost.

Both the Court and the Commission sustained the accuracy of the Company's books, adding an amount for undistributed construction costs not shown in the Company's accounts. 48

VIII.

Reproduction cost new less depreciation.

The Commission and the Court found the property in 90 per cent condition, as shown by the evidence in the present record. 49

IX.

The deduction of the depreciation reserve. 50-53

The arbitrary act of the Commission in finding the property in 90 per cent condition, and then deducting the Company's depreciation reserve, was an error of law.

Board of Public Utility Commrs. v. *New York Telephone Co.*, 271 U. S. 23. 50

McCardle v. *Indianapolis Water Co.*, 272 U. S. 400, 416. 51

Pacific Gas & Electric Co. v. *San Francisco*, 265 U. S. 403, 406.

Standard Oil Co. of N. J. v. *Southern Pacific Co.*, 268 U. S. 146, 159.

And recognized as such by the Illinois Commission in a subsequent order. 51

Wabash Valley Telephone Co. (R. Vol. IV., p. 1509).

Actual observed existing depreciation can only be deducted to ascertain present fair value. 51-52

A depreciation reserve account is a matter of bookkeeping, under the accounting rules of the Interstate Commerce Commission (see Appendix E, *post*, p. 71).

X.

Expense of depreciation.

53-5

Under the existing law (see Appendix D, *post*, p. 69), the Interstate Commerce Commission has exclusive jurisdiction of this item of accounting. 56

Oregon-Washington R. R. & Navigation Co. v. *State of Washington*, 270 U. S. 87.

Southern Railway Company v. *Railroad Com'n of Indiana*, 236 U. S. 439.

Northern Pacific Railroad v. *Washington, ex rel., Attorney General*, 222 U. S. 370.

New York Central Railroad Company v. *Winfield*, 244 U. S. 147.

Pennsylvania Railroad Company v. *Public Service Commission*, 250 U. S. 566.

Postal Telegraph-Cable Co. v. *Warren-Godwin Lumber Company*, 251 U. S. 27.

The judgment of the Company's officers as to the proper rate of depreciation cannot be set aside on the evidence in the record. 57

XI.

Present fair value.

The evidence would have sustained a much greater valuation than the minimum value used by the Court in its computations finding the proposed rates confiscatory. 57

Statements on this question in Appellants' Brief are erroneous and unreliable. 58

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XII.

Rate of return. 59-60

No distinction can be made as to a licensee company of the Bell System, nor can the Illinois Company's actual return in Chicago determine its constitutional rights to a fair return.

Conclusion. 60

ARGUMENT.

I.

Relationship between American Company and Illinois Company through ownership of stock, and effect of this relationship upon the validity of Commission's order.

Appellants' theory and argument upon this branch of the case is based, so far as it involves a question of fact, upon the exact opposite of the finding of the facts by the Statutory Court; and, so far as it involves a proposition of law, upon a direct challenge of the correctness of the rule announced by this and many other courts. Appellants' express statement to the Statutory Court of their position was that the case must be decided upon the theory that the Illinois Company does not own and operate the telephone system in Chicago, but that it is owned and operated by the American Company (R. Vol. II., p. 606).

This is, of course, a mere denial of facts not open to dispute. If the fact were as thus claimed by appellants, the Commission could not, with due regard to the Constitution, have made any such order without having the American Company before it, and giving it an opportunity to be heard as a litigant. And this was the decision of the Statutory Court (R. Vol. I., p. 181). The same observation applies to the other part of the proposition thus put forward as showing the whole theory of appellants' defense of the Commission's order: *viz.*, that the basic question is not whether the property of the Illinois Company is being confiscated, but whether the property of the American Company is being confiscated (R. Vol. II., p. 606).

The acquisition by the American Company of the stock

held by it in the Illinois Company was approved by express orders of the Commission at each step. The Commission authorized each issue of the stock by the Illinois Company, and also authorized each purchase by the American Company of the proportion of these issues applicable to the stock which it already owned (Company's Exhibits 49-A to 49-J, inclusive, R. Vol. IV., pp. 1530-1547). Such authorization was necessary both for the issuance of the stock by the Illinois Company, and for the purchase by the American Company. The controlling ownership of stock was, therefore, a situation which was not only approved, but actually maintained and enlarged by the orders of the Commission entered from 1916 to the present date.

The License Contract between the American Company and the Illinois Company, the supply contract between the Illinois Company and the Western Electric Company, and the American Company's ownership of stock of the Western Electric Company, were well known to the Commission ever since it was organized, and were involved and put in evidence in cases before it (see stipulation, R. Vol. V., pp. 1785, 1786; and 1920 order of Public Utilities Commission, R. Vol. IV., pp. 1281, 1300). The earnings which the American Company and the Western Electric Company receive from the Illinois Company under the contracts in question are paid to them, respectively, under contractual obligations. The earnings which the American Company receives from the Illinois Company by way of dividends upon its stock, are paid, not by contract between the parties, but as a right which the law annexes as a property right, inherent in the ownership of the stock, and which the Illinois Company is by law made powerless to withhold or to disregard.

The appellee, therefore, has no claim or right, direct or indirect, in the revenues received by the American Company or the Western Electric Company from their stockholding or from appellee's contract relations with the American Company or its Associated Companies.

The questions which were presented on this branch of the case may be divided into two groups.

First. What is the effect, as a matter of law, of the possession by the American Company of the power which is inherent in the ownership of a controlling majority of the stock?

Secondly. Has this power been used by the American Company in a manner detrimental to the interests of the Illinois Company, and to the public, in transactions which are material to the questions involved in this case?

The latter is a question of fact, upon which the Statutory Court made express and convincing findings against appellants (R. Vol. I., pp. 181-183).

The legal question presented by the relationship of the American Company's position as majority stockholder in the Illinois Company.

In considering this question, these indisputable facts should be kept in mind.

The appellee and the American Company are in fact distinct corporations organized at widely separated dates, under the laws of different States.

The appellee owns the telephone property with which the service is being rendered in Chicago, and it alone can exercise the rights of ownership over that property.

The American Company does not own that property, and its interest is only that of a stockholder holding a majority of the stock.

The Commission's order regulates, and can only regulate, the use of that property by the appellee, and the rates charged by the appellee for the service which it renders.

The Commission in this matter is not regulating, and cannot regulate, the rates of the American Company. That

Company is not the appellee, is not a party to this suit, and is not seeking protection against an order directed against another corporation.

The cause of action to redress the injury caused by the Commission's order lies in, and is properly asserted by, the Illinois Company, and no one else.

The power inherent in stock ownership enables the American Company to elect the directors of the Illinois Company. But this does not give it power to dominate them or to control their official action. Their duty is to the corporation of which they are officials, and not to the stockholder whose vote may have elected them. No presumption arises from such a situation, either that they have violated their duty, or have been in any way subservient to the interests of the majority stockholder.

We quote from two cases in which the rule was announced by this Court, and refer to many others cited in the Summary of the Argument, page 7, *supra*.

> "But the holding of the majority interest in the stock does not mean the control of the active officers and agents of the local company doing business in Texas. That fact gave the Pacific Company the power to control the road by the election of the directors of the Gulf Company, who could, in turn, elect officers or remove them from the places already held; but this power does not make it the company transacting the local business."
>
> *Peterson* v. *Chicago, Rock Island & Pacific Ry. Co.*, 205 U. S. 364, 391.

In *Pullman's Palace Car Company* v. *Missouri Pacific Co.*, 115 U. S. 587, 596, the Court said:

> "The Missouri Pacific owns all, or nearly all, its stock, and in that way can determine who shall constitute its board of directors; but there the power of that company over the management stops."

This is the law in Illinois, the State under whose laws both the Illinois Commerce Commission and the Illinois Bell Telephone Company were created.

Public Utilities Commission v. *Bomberger*, 275 Ill. 432, 447.

The cases relied upon by appellants involve situations radically different from those here presented. In *United States* v. *Lehigh Valley R. R. Co.*, 220 U. S. 257, the Commodities Clause of the Hepburn Act was involved, and for the purpose of deciding whether the Government should have been allowed to file an amendment to its bill, the allegations of the proposed amendment were treated as true. And those allegations were to the effect "that the powers of the Railroad Company as a stockholder were used to obliterate all distinctions between the two corporations"; and "to so commingle the affairs of both as by necessary effect to make such affairs practically indistinguishable, and therefore to cause both corporations to be one for all purposes".

In the case at bar there is no such commingling of either property or affairs; and the distinction between the corporations is as clearly marked as to property, money, records, accounts, and other details of corporate affairs, as if the American Company were not a stockholder at all.

In *C., M. & St. P. Ry. Co.* v. *Minneapolis Civic & Commerce Ass'n*, 247 U. S. 490, the Eastern Company operated a switch track over which the two railroads which owned all of its stock were given preferential rights. By contract between the Eastern Company and these railroads, the management of its affairs was placed in their hands; the powers of its directors were curtailed in essential particulars, and it was forbidden to issue stock or to select its superintendent. The Court, summing up the result of this contract, said it—

> "* * * was an obvious surrender by the Eastern Company of substantially all freedom of corporate action and an assumption of control over that company by the Milwaukee and Omaha companies, which converted it largely into a mere agency or instrumentality for doing their bidding." (p. 497.)

None of these elements, or anything resembling them, is shown in the case at bar, and the finding of the lower court is that they do not exist.

We submit that the decision of the Supreme Court of Michigan in *People, ex rel.*, v. *Michigan Bell Telephone Co.*, 246 Mich. 198 (224 N. W. 438), does not and cannot change the rule settled by this and other courts as to this point. This was a *quo warranto* case, in which it was sought to oust the Michigan Company from the right to have credit in a computation of rates for payment made to the American Company under this contract (*sic.*). In prior decisions that Court sustained these contracts, and reversed an order of the Commission making a reduction in the amount to be paid by the Michigan Company to the American Company under the License Contract. One of these cases is *Michigan Public Utilities Com'n* v. *Michigan State Telephone Co.*, 228 Mich. 658, 670 (200 N. W. 749). In that case, the License Contract was under consideration, it being contended that the amount paid to the American Company could not be treated as a proper operating expense because of the fact that the American Company owned nearly all of the stock of the Michigan Company. The Court, in reversing the action of the Commission making a reduction in the amount to be paid under this contract, recognized the rule that the contract should be closely scrutinized, but held that the questions relating to it had been passed upon by this Court in the cases which we have cited, and that those decisions were conclusive. It also referred to the decision in *Detroit* v. *Michigan R. R. Commission*, 209 Mich. 395 (177 N. W. 306), and said that all of

these decisions were "decisive of the question then presented".

The Michigan Court, in referring to its prior decisions, recognized that they were correctly decided, and would be conclusive in a rate case, but said that the issue and the principles of law were essentially different in a *quo warranto* case. But, upon petition by the defendant company to amend the judgment (and briefs in opposition thereto by the plaintiff), the Court amended its final decree by providing that:

> "* * * but nothing herein contained shall be construed to affect the right of the Michigan Bell Telephone Company upon its making proof thereof in accordance with the requirements of due procedure to have included in such computation of rates the reasonable value of the services rendered and the facilities furnished by the American Telephone and Telegraph Company." (Bulletin of Current Decisions, American Telephone and Telegraph Company, No. 3432, not officially reported.)

The case, therefore, upon the statement of the Court itself, seems clearly to stand as a decision that in a rate-making case, such as the case at bar, these contracts are to be treated by the Michigan Commission as valid.

It will be noted also that the original decision in this extraordinary case, was by a divided Court, and that the judge who wrote the dissenting opinion correctly held that the Court could not be called upon to render what would be in effect a declaratory judgment, but should leave the Commission free to determine such questions as these when they arose.

The decision in *Chesapeake & Potomac Telephone Co.* v. *Whitman*, 3 Fed. (2) 938, upon which appellants acted, does not sustain their theory, but expressly recognizes our position. It was there said (p. 957):

> "The so-called license contract under which the Maryland Company pays the National 4½ per cent of its gross revenues is identical in terms with that

between the National Company and the Southwestern Bell Company, which figured in *Houston* v. *Southwestern Bell Telephone Co.*, 259 U. S. 318, 42 S. Ct. 486, 66 L. Ed. 961, and in *Missouri, ex rel., Southwestern Bell Telephone Co.* v. *Public Service Commission*, 262 U. S. 276, 43 S. Ct. 544, 67 L. Ed. 981, 31 A. L. R. 807, and also with that between the National and the Southern Bell Telephone & Telegraph Company in issue in the case of the last mentioned corporation against the Railroad Commission of South Carolina. (D. C.) 299 Fed. 615.

"By these cases it is settled that, in the absence of some showing of bad faith, such contracts are binding upon local telephone companies, and must be respected by commissions and courts, provided that the Company clearly shows that the charge made and allowed for the services rendered and supplies furnished was reasonable, and less than that at which the same could be obtained from other sources. *Houston* v. *Southwestern Bell Telephone Co., supra.* The evidence on this point offered upon the part of the Company was convincing."

The question of the actual exercise of domination and control by the American Company over the officials of the Illinois Company.

It is settled by the authorities to which we have referred that control over the Illinois Company, or its officers, does not result from this stock relationship. It becomes then a question of fact whether such domination and control were actually exercised over the officials of the Illinois Company in such a manner as would invalidate the transactions between the two Companies, or bring the case within any other rule of law.

Domination and control over the appellee's officials, as used in this connection, must necessarily have a sinister meaning. It means something which is essentially bad,

and which is injurious to the appellee and the public in its results. To have the effect claimed by appellants, it must be such control by the officials of the American Company over the judgment and actions of the officials of the Illinois Company, that the latter have no liberty of judgment or action on behalf of their own Company, but act according to the wishes of the officials of the American Company. Appellants' theory involves an affirmative charge against the good faith of the officials of the Illinois Company. The presumption of law is against the truth of this charge.

Pullman's Palace Car Co. v. *Missouri Pacific Co.*, 115 U. S. 587, 596.

Porter v. *Pittsburgh Bessemer Steel Co.*, 120 U. S. 649, 670.

Peterson v. *Chicago, Rock Island and Pacific Ry. Co.*, 205 U. S. 364, 391, 393.

Houston v. *Southwestern Bell Telephone Co.*, 259 U. S. 318, 323.

Missouri, ex rel., Southwestern Bell Telephone Co. v. *Public Service Com'n*, 262 U. S. 276, 288, 289.

Indiana Bell Telephone Co. v. *Public Service Com'n*, 300 Fed. 190, 204.

Northwestern Bell Telephone Co. v. *Spillman*, 6 Fed. (2) 663, 664.

Some element must be brought into the relationship between these Companies other than that which necessarily arises from the fact that they have contracted with each other. That relationship always exists between contracting parties, and the intent of the contract is to create it.

The result brought about by the contract must be, in a legal sense, an evil one, before we are really at the

starting point for the determination of the ultimate question, as involved in this case. If it is an evil one, because so injurious to one of the parties as to show that those who acted for that party in making it could not have exercised their official power with honest judgment for its interest, then the question may arise whether they acted in obedience to control of their actions, as distinguished from control by their own judgment. However, if the result produced by the contract is not an evil one in this sense, but is meritorious, then the question of domination and control does not arise at all; and certainly the good result rebuts any presumption of wrongdoing.

On the other hand, a contract which is injurious to the public in its effect may be illegal, even if both parties acted at arms length, and with no control by one over the other; but that element is absent in this case. The public is not injured by unified action in telephone service, but is benefited by it, and such action is necessary to produce it. This is settled in Illinois, whose law on that question binds both the Commission and the Illinois Company.

Public Utilities Commission v. *Romberg*, 275 Ill. 432, 447.

No case cited by appellants holds, as stated in their brief (page 252), that in cases of this kind fraud or bad faith is not an essential element.

The case of *United Fuel Gas Company* v. *Railroad Commission*, 278 U. S. 300, does not so state, but, on the contrary, re-affirms the principles previously laid down in the cases which we have cited. In that case, the company against which the regulatory action of the Commission was directed, and which appealed to this Court, was the company which held the stock of the Warfield Company, which was operating locally in Kentucky. The stockholding company had previously operated in that State, but after

the expiration of its franchise to operate, it continued the service until it had organized the Warfield Company, all of whose stock it owned and to which it had conveyed its Kentucky property. It then attempted to withdraw from its business in Kentucky, contrary to the provisions of the laws of that State. It had unsuccessfully raised these questions in the State Courts, and the decisions against it were treated by this Court as withholding from it the right of federal interference upon the unconstitutionality of the statute whose provisions it had invoked. Upon attempting to withdraw from operating in Kentucky, the rates had been raised to a much higher price, which showed a profit of over 100 per cent. The action complained of there was not merely against the local company, but against a company which had actually been operating in Kentucky, and which, by the valid laws of that State, was forbidden to withdraw its operations. The question, whether it could be treated as operating, because of its relationship to the local company, was not made a substantial issue. Upon that point the Court said, page 308:

> "Appellants do not seriously deny that the Warfield Company (the local corporation) is but an agency organized by the United Company (the stockholding company) for the purpose of carrying on its public service business in Kentucky, or that through that agency the latter is doing business in the cities named and elsewhere in the state."

The situation of the parties in that case, and their relationship, were exactly the opposite of those here involved. In the case at bar, the proceeding is not against the American Company as being the Company which operates in Illinois, and that Company was not in any way before either the Commission or the Court. No proceeding affecting the American Company's property or rights in Illinois, even if it were determined to be technically

engaged in business in that State, could stand against constitutional objections to their validity, where it was not a party to the proceeding.

In addition to these distinctions between the case at bar and the decision in the Kentucky case, upon which appellants rely, it is to be noted that, so far from sustaining their theory of the right to review the contracts for the amounts paid to the American Company under the License Contract, or to the Western Electric Company under the supply contract, the Court said that a public service commission, under the guise of establishing a fair rate, may not usurp the functions of the company's directors, and in every case substitute its judgment for theirs as to the propriety of contracts made by the utility; and that a common ownership is not of itself sufficient for disregarding such intercorporate agreements, "when it appears that, although an affiliated corporation may be receiving the larger share of the profits, the regulated company is still receiving substantial benefits from the contract, and probably could not have secured better terms elsewhere".

Upon this proposition, the Court refers to its prior decisions in *Missouri, ex rel., Southwestern Bell Telephone Co.* v. *Public Service Commission*, 262 U. S. 276, 288; *Houston* v. *Southwestern Bell Telephone Co.*, 259 U. S. 318, **which cases involve the identical relationship and the identical question presented in this case, and are decisive here against the contention of these defendants.**

The fundamental difference between the power inherent in a company which holds the majority of the stock of a subsidiary company, and the exercise of control by electing directors, etc., is well stated in the opinion of Judge Hand in *Kingston Dry Dock Co.* v. *Lake Champlain Transportation Co.*, 31 Fed. (2) 265, decided in 1929. He there clearly points out the necessity of actual interference and management in the affairs of the company whose

stock is thus held, and in such a way, by the intention of the parties, as to make the operating company a mere agent. The statement of the effect of the authorities, and of the facts which must be shown, is thus stated:

> "Control through the ownership of shares does not fuse the corporations, even when the directors are common to each. One corporation may, however, become an actor in a given transaction, or in part of a business, or in a whole business, and, when it has, will be legally responsible. To become so it must take immediate direction of the transaction through its officers, by whom alone it can act at all. (Citing cases.) At times this is put as though the subsidiary then became an agent of the parent. That may no doubt be true, but only in quite other situations; that is, when both intend that relation to arise, for agency is consensual. This seldom is true, and liability normally must depend upon the parent's direct intervention in the transaction, ignoring the subsidiary's paraphernalia of incorporation, directors and officers. The test is therefore rather in the form than in the substance of the control; in whether it is exercised immediately, or by means of a board of directors and officers, left to their own initiative and responsibility in respect of each transaction as it arises. Some such line must obviously be drawn, if shareholding alone does not fuse the corporations in every case."

In the case at bar, the corporate management of the Illinois Company is entirely separate from that of the American Company, nor does the latter, in fact, direct the affairs of the former, either by contract or interlocking directorships, or otherwise.

The findings of the Statutory Court that the American Company did not in fact exercise any control over the officials of the Illinois Company are sustained by the evidence.

The Chairman of the Board of Directors of the Illinois Company for eight years, who prior thereto had been President of the Company since 1908, was called by the

City as its witness, and testified that during the time of his connection with the Illinois Company, the American Company had at no time interfered with the functions of the directors or officers of the Illinois Company; and that he had never been ordered by the American Company, or by any officer, to do or not to do anything in connection with the operating of the Illinois Company (R. Vol. V., p. 1599).

The Comptroller of the American Company testified as the City's witness and stated that the American Company aimed to have the relations between the Associated Companies and the American Company on the basis of two separate and distinct companies dealing with each other; that he has asked the same credentials, the same paper and the same authority from the licensee companies as their bank would ask if an outsider came to borrow money (R. Vol. V., p. 1811).

The operating Vice President of the Illinois Company, formerly its Chief Engineer, testified that during his telephone experience he did not know of any instance where the American Company, through its officers or its general staff, had attempted to do more than advise or assist the licensee companies (R. Vol. III., p. 1072); that as to matters of policy involving the entire Bell System, he would not want to make a decision without discussing the problem and getting the consent of the American Company, but that his obligation was to the Illinois Company, and that no matter how much it might affect the balance of the System, he could decide any question without the consent of the American Company, and could overrule its advice (R. Vol. III., pp. 1074-1075).

The organization charts of the American Company (Company's Exhibits 53, 54, 55 and 56, R. Vol. IV., following p. 1550) and the Illinois Company (Company's Exhibits 73 and 74, R. Vol. IV., following p. 1566) show that the

organization and the general staff of the American Company are of an advisory character, and that the organization of the Illinois Company is that of an operating company (R. Vol. III., p. 1071); that there is no duplication of organization; that the organization of the American Company could not successfully operate the Illinois Company and perform its functions, and that the Illinois Company could not perform the functions of the general staff of the American Company (R. Vol. III., pp. 1057-1076). There is no identity of officers, employees or organization. The functions of the two Companies are distinct, but their relations are covered by contract in exactly the same manner as if the American Company did not own any stock in the Illinois Company.

Mr. J. G. Wray, who was the City's leading expert witness, and who had been with the Illinois Company twenty-three years, could only recall one instance wherein he thought his own action had been controlled to the extent of domination. When the original correspondence on this question (which arose in 1907) was produced, it was found that the dispute had been one between Mr. Wray and his superior in the Illinois Company, and not between the engineering staff of the American Company and the Chief Engineer of the Illinois Company, and had been settled in a manner satisfactory to all by mutual agreement on an engineering problem (Company's Exhibits 61, 62 and 63, R. Vol. IV., pp. 1551, 1553 and 1555; and R. Vol. III., p. 1002-1003). The Statutory Court very properly comments on the character of Mr. Wray's testimony in disposing of the unsuccessful attack by the same witness on the method used by the Company in valuing its property (R. Vol. I., p. 196).

The Court disregarded the historical documents introduced by the City, such as the Western Union Contract of 1879, the original License Contract of 1881, the contract with the Western Electric Company of 1882, the contract between the American Company and its predecessor of

1889, and the numerous contracts between the American Company and the Southwestern Bell Company, which do not have any bearing on the relations between the American Company and the Illinois Company in 1923 or in subsequent years.

The giving of advice by one company to another is not an exercise of domination or control over the company to which the advice is given, nor is the following of such advice evidence of subserviency on the part of the company receiving the advice; if the advice is sound, it is the part of wisdom, and perhaps of duty, to follow it. A result obtained by mutual action or agreement is not tainted with fraud because of mutuality of interest in the result, or mutuality of action in attaining it.

The efforts of the Bell System to secure universal telephone service by a general policy with reference to matters which affect the service of all companies, do not sustain the appellants' contentions.

It is now settled that competition between telephone companies is contrary to the public interest, because it produces poor service. Regulated monopoly in this business is universally regarded as far more conducive to the production of the good service to which the public is entitled, than competition, which produces the evils of two separate telephone systems in the same territory. It is for this reason that regulatory commissions are created, and given power, not only to regulate rates and thus prevent one of the old evils of monopoly, but to prohibit a company from engaging in service in a territory in which service is already being rendered.

In the telephone business the end to be attained is efficient universal service. This requires the unity of many operating units in the use of methods effective in attaining

that end. Thus, neither the end to be attained—universal service, nor the means adopted to attain it, have any taint of illegality. It is not a case of an illegal end making the means illegal, or *vice versa*.

This is settled as the law of Illinois from which the Commission derives its powers; and the rule was applied to a purchase by the American Company of a controlling interest in a telephone company. The Court said:

> "The interests of the public are not best served by competition in the telephone business, but by the consolidation and merger of competing lines and regulation as to rates and service by the state or some agency thereof."
>
> *Public Utilities Commission* v. *Rowberry*, 275 Ill. 432, 445.

The fact, therefore, that a system is created by which many separate companies, operating in different localities, strive in unison to attain the result of universal service, and by mutual effort to devise the best means, both in general and in detail (see, for example, City's Exhibit 132-F, R. Vol. VI., p. 2323), of bringing about and maintaining that result, is not an evil in itself because it produces a co-operating system, or because it might tend to lessen competition.

The annual reports of the American Company.

These reports from 1880 to 1928 were offered by the City (R. Vol. VII., pp. 2349-2683), and admitted in evidence, apparently upon the theory that they were competent evidence against the Illinois Company, and would show that its officials were dominated by the American Company, or that there was a corporate identity between the American Company and the companies in which it is the holder of majority stock, as in the case of the Illinois Company. None of these reports emanated from the Illinois Company, and they cannot be treated as if they

were statements made by it. But, aside from this, they really have no evidentiary value whatever on this question, to say nothing of their sufficiency to overcome the fact that the corporations are entirely separate; were organized under the laws of different States; that their properties are distinct and are separately operated; and that they have acted in entire good faith in all transactions between the Companies. These are stubborn facts which could not be changed by general statements by the American Company of the character shown in the few examples selected for comment by counsel out of the great mass of these reports.

Our view, and that of the Court below, is sustained by the decisions in several cases in which reports and statements of this kind were relied upon to show that there was an identity of the kind contended for between two corporations, one of which owned the stock of the other.

In *Peterson* v. *Chicago, Rock Island and Pacific Ry. Co.*, 205 U. S. 364, the defendant's report, covering "operations as affairs of the operated lines and auxiliary companies forming the Rock Island System", was relied upon as showing that the local company was the "mere creature" of the company holding its stock. The contention was rejected.

To the same effect is *Holland* v. *Holland City Gas Co.*, 257 Fed. 679 (C. C. A. 6th Circuit 1919), where it was claimed that a corporation had been "supplanted" by another corporation which owned all its stock and bonds, and had issued a prospectus containing statements as to the relations between the companies. Of these the Court said (p. 682):

> "* * * the company at times speaks in terms which at first sight create a wrong impression as to the actual relationship between the Delaware company and the companies in which it is interested."

Such words and expressions were used as "controlled", "constituent companies", "subsidiary companies",

"properties intrusted to its management", and so forth. With reference to these, the Court held (p. 683):

> "The prospectus and reports, however, when considered as an entirety, show that the terms in dispute were employed as convenient means for identifying and differentiating companies and objects, and not to describe precise corporate relationships. This is made clear by other and explicit statements."

The Court further held that ambiguous statements in one of the reports, which, it was claimed, asserted "ownership" of subsidiary properties, must be read in connection with specific statements in the same report, showing that those companies were controlled through stock ownership. The Court said in part (p. 684):

> "Whatever, then, may in other respects be said of the relations between the Delaware company and the gas company, *we cannot think that the use of doubtful phrases, like those shown in the prospectus and reports just considered, warrants a conclusion that the stockholder, the Delaware company, had become the owner, as appellants allege, of the franchise and property standing in the name of the gas company* * * *."

To the same effect is *Elenkrieg* v. *Siebrecht* (New York), 144 N. E. 519; 238 N. Y. 254, where there was a suit for injuries received on the property of the Siebrecht Realty Company, of which Siebrecht was the principal stockholder. The plaintiff contended that the corporation was a subterfuge; that in reality it did not exist; and that Siebrecht was the real owner of the building and was using the corporation as a cover to the actual ownership. In support of this contention, the plaintiff offered in evidence certain letters written by Siebrecht, in which he referred to the building as "my premises". A judgment of the State Supreme Court affirming a judgment entered upon a verdict in favor of the plaintiff, following a denial of defendant Siebrecht's motion to dismiss, was reversed by the Court of Appeals and the

complaint against him was dismissed. The Court said in part (p. 521):

> "Merely because Siebrecht referred to the property as his property cannot overcome the undisputed fact of the corporation's existence and ownership. * * * The fact that one man may own all but a few shares of the stock, and be in fact the dominant and controlling factor or the only active manager of the corporation, is no evidence in and of itself that the corporation does not exist as a person in the eyes of the law actually owning, operating, and controlling property."

See also *General Motors Corp.* v. *Moffett* (Ohio), 160 N. E. 878.

If the annual reports are admissible in evidence, and prove anything as mere statements of the intent of the American Company, they show that its purpose is to give the public the best possible telephone service at the lowest possible cost, conforming to legal methods of corporate organization, intercorporate relationship, and lawful regulation (R. Vol. VII., p. 2671).

II.

License Contract payment.

The American Bell Telephone Company, predecessor of the American Telephone and Telegraph Company, acquired from Alexander Graham Bell, the discoverer and inventor of the telephone, his original Letters Patent granted March 7, 1876, which marked the beginning of telephony—not an improvement upon an existing art, but a new art.

Under a License Contract with the American Company entered into when the Illinois Company was organized in 1881, which was rewritten into the present form by a contract executed in February 1919 (Company's Exhibit 7, R. Vol. IV., p. 1196), and approved by the Board of

Directors of the Illinois Company (City's Exhibit 115, R. Vol. VI., p. 2163), the American Company furnished to the Illinois Company all of the telephone instruments used by the Illinois Company in the City of Chicago; licensed the Illinois Company under all the patents owned by the American Company and the Western Electric Company; agreed to furnish the Illinois Company advice and assistance in all engineering, plant, traffic, operating, commercial, accounting, legal and other matters pertaining to the conduct of the telephone business of the Illinois Company; and agreed to continually prosecute the fundamental work of research, investigation and experimentation in the art of telephony, and to give the Illinois Company advice and assistance in connection with its financing. The provisions of this contract are substantially the same as those of contracts with all other operating telephone companies constituting a part of the Bell System (R. Vol. III., p. 978). The testimony in the record shows that the present development of the telephone art in the United States is a result of the License Contract, and the services rendered by the American Company thereunder; that the engineering staffs of the American Company and the Western Electric Company have, by their research and development, perfected and manufactured for standard use throughout the country, the present modern types of apparatus and operating methods; and that enormous savings have accrued to the licensee companies as a result of the research and development work of the American Company (R. Vol. III., pp. 975, *et seq.*). The size of the organization of the American Company engaged in development and research steadily grew, so that in 1928 there were over 7,000 employees, of whom over 3,000 were trained scientists, college graduates or engineers (R. Vol. III., p. 996), and the number of patents owned or controlled by the American Company had increased to 9,800, with 2,000 applications pending (R. Vol. III., p. 983).

The record shows that the Illinois Company has always received the benefit of these services rendered by the American Company; that in the opinion of its operating officers it has required the services enumerated, has received them, and their value to the Company has been greater than their cost (R. Vol. III., p. 1044). The President of the Illinois Company when the License Contract was entered into in its present form (whose record with the Company goes back to 1879, and who was continuously with the Company as an executive from 1908), testified that substantially the same services were rendered by the American Company to the Illinois Company prior to the execution of the 1919 contract (R. Vol. V., p. 1601); that he considered the amount of compensation provided for under the contract to be fair and reasonable from the standpoint of the Company during the entire period of the contract (R. Vol. V., p. 1601); that he could not conceive of a satisfactory telephone system without standardization; and that the original plan of licensing operating companies and acquiring a manufacturing company, as blocked out mostly by Mr. Vail, was a stroke of genius, and has led to the building of one comprehensive, complete telephone system (R. Vol. V., p. 1602).

Mr. J. G. Wray, the principal witness for the City of Chicago, who had been employed by the Illinois Company from 1893 to 1916, and had been its Chief Engineer from 1911 (R. Vol. V., p. 1710), stated the numerous benefits from the relation between the Illinois Company, the American Company and the Western Electric Company, and that the American Company's engineering and other services enabled the Illinois Company to prepare its plans more quickly and more cheaply, finance more readily, and get its materials promptly and in adequate amounts to carry on its construction work in the most economical way (R. Vol. V., pp. 1718-1719). No other witness for the appellants testified on the subject, the City refusing to examine the

Comptroller of the American Company as to the cost to that Company of rendering the services to the Illinois Company, although such information had been originally requested by the City (R. Vol. V., p. 1828), and was available.

An attempt has been made to demonstrate from a defective record that the Illinois Company, over a period of years, has received fewer financial services from the American Company than other licensee companies have received. This argument is manifestly unsound and inapplicable to the question of whether the License Contract constitutes an abuse of discretion on the part of the Company's officers, since all the enumerated services were available and rendered when needed, and there is ample uncontradicted proof in the record that the value of the services rendered, greatly exceeds the payment therefor made to the American Company, and that the services could not be obtained elsewhere at any less cost to the Illinois Company (R. Vol. V., pp. 1601-1602; R. Vol. III., pp. 1070-1073; R. Vol. III., pp. 1034-1057).

The Statutory Court did not approve the disallowance of any portion of the payment made by the Illinois Company to the American Company under the License Contract, but followed in its calculations the decisions of the Illinois Commission and its predecessor, disallowing a small portion of the License Contract payment. The Court expressed its conviction that the case in the record for the allowance of the entire amount was a strong one (R. Vol. I., pp. 190-191). It is submitted that the Court, if necessary to the decision of the case, should and would have approved the entire payment. The License Contract has been approved in two decisions of this Court which specifically mention the services rendered thereunder, and with few exceptions by all courts and regulatory Commissions which have considered the question (see Appendix A, *post*, p. 61).

If companies subject to regulation are not permitted to exercise managerial judgment in providing for the development of their business by reasonable contracts, there could not be scientific research by competent organizations and the resulting improved service and decreased costs.

III.

Western Electric contract.

That this contract for the purchase of materials and supplies is of great advantage is shown by the testimony of the principal witness thereon (R. Vol. III., pp. 1076, *et seq.*), and the exhibits showing the relationship between the two Companies (Company's Exhibit 64, R. Vol. IV., following p. 1556), and the benefits derived therefrom by the Illinois Company (Company's Exhibits 65-70, inclusive, R. Vol. IV., pp. 1556, *et seq.*). Despite the objections of the City to the introduction in evidence of the annual reports of the Western Electric Company (R. Vol. III., p. 1104), this witness testified without objection that the average profits for the last fourteen years to the Western Electric Company on its total business had not been in excess of 7 per cent, and never above 10 per cent (R. Vol. III., p. 1134). It appeared that the Western Electric prices to licensee companies are from 20 to 36 per cent lower than those charged by other manufacturers for comparable material [or charged by the Western Electric Company to independent telephone companies (R. Vol. III., pp. 1087-1088)], some 46 per cent of the articles being comparable (R. Vol. III., p. 1113). By comparing Western Electric prices to other than Bell Companies, by the comparison of the actual purchases of the Illinois Company from the Western Electric Company in 1921, and by an examination of the actual purchases of independent telephone companies from other manufacturers, the advantages were shown of a

manufacturing department in the telephone business, of a general purchasing agent with tremendous buying power, and standard inspection of all products (R. Vol. III., pp. 1087-1091).

All of the Associated Companies in the Bell System have an identical contract with the Western Electric Company, and it has been sustained by every court and practically every Commission that has considered it (see Appendix B, *post*, p. 65).

IV.

Interstate separation.

In the proceedings before the Illinois Commerce Commission, neither the Company nor the Commission made any attempt to separate the interstate property, revenues or expenses, so the Commission's enjoined order considered the case upon the basis of all property, revenues and expenses. The Company, in its bill of complaint herein, and in the evidence offered in support thereof, made a separation of its interstate property (R. Vol. II., pp. 828, *et seq.*), revenues and expenses (R. Vol. II., p. 824), upon the basis of use, having in mind the decisions of this Court requiring such separation in confiscation proceedings. The Statutory Court approved appellee's method of separation and the results thereof, but disregarded the computations in its opinion, on the grounds that the consideration of the total property was the most unfavorable basis to the Company's claim of confiscation; that the difference in the two methods could not affect the result; and that it was more convenient, for the purposes of comparison with the order of the Commission, to consider the total property (R. Vol. I., pp. 184-186).

The Court found against the appellants' theory that the method of separation should have been based upon the use of a portion of the exchange property of the Company, that is to say, the use of the telephone equipment from the subscriber's telephone to the toll board. The method employed by the Company was upon the basis of the use from the toll switchboard, or, to be more exact, the toll recording trunks and the toll switching trunks leading to the toll board (R. Vol. II., p. 834). The Company's method of separation was that used and approved as to similar interstate business in the Seattle case, *Pacific Telephone & Telegraph Co.* v. *Whitcomb*, 12 Fed. (2) 279; affirmed 276 U. S. 97; by the New York Telephone Company in its state-wide case, *New York Telephone Co.* v. *Prendergast*, 300 Fed. 822, 827; and on final hearing, 36 Fed. (2) 54; by the Kansas Supreme Court in *State, ex rel., Hopkins* v. *Southwestern Bell Telephone Co.*, 223 Pac. 771; and by the numerous State Commissions which have considered the question. (See list of Commission cases in Appendix C, *post*, p. 68.) For example, the Rhode Island Commission stated, in *Public Utilities Commission* v. *New England Telephone and Telegraph Co.*, Public Utility Reports 1926-C, 207, 261:

> "After a careful consideration of all of the evidence bearing upon the relative merits of the board-to-board and station-to-station methods of apportionment of interstate and intrastate property, revenues and expenses, we are of the opinion and find that it is a fundamental condition of satisfactory telephone service that there shall be two separate and distinct rate structures, one for exchange and one for toll service; that the board-to-board basis, where the exchange rates cover all service rendered by the use of the exchange system, and the toll rates cover all service rendered by the use of the toll system, meets the requirements of simplicity, stability, and equity; that the board-to-board basis has practically without exception met with the approval of Commissions and courts; that almost without exception the rate structures of telephone

> companies in this country are built upon the board-to board basis; that the board-to-board basis, has been approved by the Commissions in the four other New England states in which the company operates; and that an attempt to apply the station-to-station theory to all toll use, interstate and intrastate, would result in almost utter confusion, and would work untold injury to the development and extension of telephone use."

The toll rates filed by the Company provide the basis for the method of separation followed (Company's Exhibit 13, R. Vol. IV., p. 1271), and the contract with the American Company, which connects with the Illinois Company at the City limits of Chicago, is premised upon the same basis as that upon which toll rates are fixed, *i. e.*, measurement from the toll board to the toll board, and not from the subscriber's telephone to the subscriber's telephone (Company's Exhibit 7, R. Vol. IV., pp. 1196, 1204-1205).* Therefore, the question at issue depends upon the selection and classification of the units of service to be offered to the public by the rate structure of the utility, and is a right of management not subject to police power, as determined by this Court in *Chicago, Milwaukee & St. Paul Ry. Co.* v. *State of Wisconsin,* 238 U. S. 491.

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*In the footnotes on pages 43 and 63 of Appellants' Brief, it is stated that long distance rates "cover" connections between stations, and the same statement in different form is made on page 71. The citation to the record supporting this erroneous assertion (R. Vol. VI., p. 2319) is an exhibit consisting of part of the Chicago telephone directory showing, not the toll rates, but the method of giving toll service, which, for many years, has included two distinct kinds of service, one a long distance call to a telephone number, known as "station-to-station service", and one a call to a particular person, called "person-to-person service".

The witness who made the interstate separation of

Previous decisions of this Court approve separations on a reasonable basis, and disregard the purely negative attitude adopted by appellants, of criticizing the separation but offering no affirmative evidence:

Rowland v. *St. Louis & San Francisco R. R. Co.*, 244 U. S. 106, 108.

Groesbeck v. *Duluth, S. S. & A. Ry. Co.*, 250 U. S. 607, 614.

There is a method used as a matter of convenience and economy in determining the reasonableness of exchange rates which includes only a partial separation. All property used exclusively for long distance service (toll switchboards, etc.), is omitted from the valuation, and all expenses exclusively toll are omitted, such as toll operators' wages.

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revenues and expenses testified that the board-to-board basis of separation had not only been used in the case at bar, but that he had made an interstate separation on the same basis for three other licensee companies of the Bell System, and that in all these cases, including the present case, the interstate toll rates had been fixed by the filed schedules, not from station to station, but from board to board; and that the only exception (which did not include interstate business) was in the case of the New York Telephone Company, where the local toll rates had been filed from station to station, and the separation had, therefore, been made as to local toll rates, but not as to interstate rates upon the station-to-station basis (R. Vol. II., p. ~~516~~ 846). The record, therefore, was very clear and definite on the question of the method of fixing interstate toll rates.

Appellants' absolute misstatement of the facts in the record was made evidently upon the theory that this Court would not perceive the distinction between the method of determining the toll rates to be charged a subscriber, and the different kinds of service given to the subscriber under the toll rates as filed (see the Illinois Company's toll rate schedule and classification, R. Vol. IV., p. 1271), and shows the same apparent lack of familiarity with the subject matter which was so evident upon the trial of the case below (see R. Vol. II., pp. 779-781).

This leaves in the valuation that portion of the telephone property used partially in interstate service (from the exchange switchboard to the toll switchboard), and includes the expense of maintaining and operating such property, and the expense of accounting and collecting for long distance messages. To offset this expense of maintenance, operating, billing and collecting, the exchange is compensated with the total originating commission.

The usual division of long distance messages between telephone companies is made upon the basis of crediting the Company originating the toll message with a commission, and dividing the balance of the total revenue received from the message *pro rata* upon the mileage of the two or more companies handling the toll message (R. Vol. II., pp. 778, 785, 854-855). The method of partial separation referred to, in effect treats the exchange as if it were a separate independent company, and therefore credits to the exchange the total originating commission, to compensate the exchange for the expense of operating all partially used property, and for billing and collecting.

This convenient short-cut to a complete interstate separation was used in the *Houston case* in this Court, where the bill of complaint alleged confiscation of the "telephone exchange property constituting the Houston telephone exchange". The statement of the method is found in the Company's brief in the *Houston case* in this Court (pp. 26-31), and is referred to in the decision of the Master and the District Court, found in the transcript of the record in the *Houston case* (Houston Transcript of Record, Vol. I., pp. 37, 55).

The City of Houston in its brief squarely contended that a part of the exchange property, *i. e.*, the subscriber's telephone and the connection with the exchange switchboard,

should have been excluded from the exchange valuation as toll property (City's brief, *Houston* case, p. 35, and supplemental brief, p. 6). The Statutory Court, which had the Houston record and briefs before it, is, therefore, entirely correct in stating that an examination of the facts in the Houston case demonstrated that this Court did not sustain appellants' theory of including a portion of exchange property as interstate property.

When this Court referred in its opinion in the *Houston case* to "compensation for the use made of the local plant in rendering long distance service" (259 U. S. 318, 322), it could not have referred, on the basis of the record before it, to compensation for the use of exchange plant consisting of the subscriber's station and connection with the exchange switchboard, but had before it a case involving only a partial separation, and referred, therefore, to compensation for the use of the property from the exchange switchboard to the toll switchboard, partially used in interstate communication; hence there is no possible conflict between the decision of this Court in the *Houston case*, based upon a partial separation, and the opinion of the Statutory Court on the record in the present case, which contains a complete interstate separation upon the basis of use.

V.

Division of tolls.

If the Court had decided the case on the basis of the interstate separation, there would have been, obviously, no question presented of the division between the American Company and the Illinois Company of the revenue received for interstate tolls, but since the Court disregarded the interstate separation, after approving the basis thereof, it considered and found that the division of tolls

between the American Company and the Illinois Company was reasonable.*

The long distance tolls, as to the Chicago exchange, are divided under a long existing arrangement by which the American Company pays an originating commission of 17 cents per message (approximately 2,000,000 messages in 1923), and in addition thereto pays the Illinois Company the actual cost to it of operating the toll switchboard and the toll lines in Chicago, plus 10 per cent for overhead and a return of 10 per cent on the book cost of said property (R. Vol. II., pp. 839-840). The Illinois Company owns and operates all the property used in the City of Chicago for interstate calls (R. Vol. II., p. 836). After the originating commission is deducted from the total long distance charge, there is no pro rate in Chicago upon the mileage haul of the message in the Chicago exchange, since the Illinois

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*The Statutory Court stated that "the sinister influence which the City seeks to have drawn from certain changes in the arrangement is not warranted by the facts" (R. Vol. I., p. 187). Prolonged discussion of the historical changes in the contract relations on this subject between the American Company and the Illinois Company, therefore, appears unnecessary, but we point out that the method of dividing the tolls first referred to in the contract of 1881 is more specifically determined in the contract of 1891, and carried into the License Contract of February 1, 1919; and that no change of any character of the basis of the division of Chicago long distance tolls between the two Companies was made when the 1919 contract was entered into, or thereafter, as a result of said contract.

Appellants' assumption that the 1881 contract required the American Company to pay, by the division of tolls, compensation for the use of the exchange plant, and that such right was relinquished by the contract of 1919, is incorrect, as shown by the testimony of their own witness, who was familiar with the situation in 1911, prior to the execution of the 1919 contract (R. Vol. V., p. 1740).

Company is compensated therefor by the payment of the actual cost of operation, as aforesaid.

As the Statutory Court stated, these payments resulted in the Illinois Company's retaining nearly 50 per cent of the total gross originating long distance revenue (Company's Exhibit 77, R. Vol. IV., p. 1571; and Company's Exhibit 24, R. Vol. IV., p. 1349), and enabled the Illinois Company to earn 12.64 per cent on the book cost of its interstate toll property, while the return on its exchange property was only 5.74 per cent on its book cost (R. Vol. I., p. 187). Moreover, the amount which the Illinois Company pays under contracts approved by the Illinois Commission with several hundred independent telephone companies in Illinois, as an originating commission, is much less than the amount it receives from the American Company as an originating commission (R. Vol. II., pp. 854-855); and the amount which the Illinois Company receives for its Chicago exchange on the division of tolls is much more per message than it receives on its division of tolls with the American Company outside of Chicago under an arrangement which is practically uniform throughout the United States (R. Vol. II., p. 855). The evidence, therefore, amply supported the Court's finding.

VI.

Reproduction cost new.

The Commission found the reproduction cost new of the property as of December 31, 1922, to be $128,769,000. The Court found that the Commission, in arriving at this figure, had omitted the net additions to the Company's property from December 31, 1921, to December 31, 1922, amounting to $8,292,869, the evidence supporting this finding on the omitted net additions being as follows:

There was no evidence before the Commission as to the reproduction cost new of the property on December 31,

1922 (R. Vol. II., p. 683); only evidence as to December 31, *1921*, of a reproduction cost of $114,973,457 of the structural property, without overheads (R. Vol. II., p. 683). The Commission allowed 12 per cent for overheads (R. Vol. I., p. 23), which, added to the December 31, 1921 amount, totals $128,769,000 as the total reproduction cost of December 31, *1921*, exactly the amount found by the Commission as the total reproduction cost as of December 31, *1922*. By this error, $8,292,869 of the Company's property, built in 1922 (R. Vol. II., p. 762), was omitted from the Commission's finding of value. With this necessary correction, the Commission's reproduction cost new becomes $130,292,849 as of December 31, 1922.

When net additions are added from January 1, 1923, to June 30, 1923 (without any correction for changes in prices from December 31, 1922), the Commission's reproduction cost new becomes approximately $147,000,000. The evidence of the Company as to reproduction cost new before the Court showed $145,248,344, and the Court found a reproduction cost new of $145,000,000, approving the method of appraisal used by the Company, which the City's experts (discredited by the Statutory Court) claimed to be unsound (R. Vol. V., pp. 1627-1669, 1710-1775).

VII.

Original cost.

The original cost of the property on June 30, 1923, was found to be $101,600,000, which is in accordance with the Commission's finding. The cost of the Company's property, as shown by the Company's books as of the same date, was $95,820,390 (R. Vol. II., p. 761), the Company having agreed, for the purpose of the record in the present case, that undistributed construction costs, or overheads, omitted from the Company's books, should

be added to this book cost in the amount of only $5,000,000, in accordance with the order of the Commission. The Company's Appraisal Engineer testified as to the trend of actual prices of labor and material entering into the telephone company's construction costs in Chicago from 1914 to 1925, which he computed into a curve (Company's Exhibit 44, R. Vol. IV., following p. 1426), and stated that, in his judgment, the total cost of the construction new of the same physical property on June 30, 1923, would exceed the original cost by at least 30 per cent (R. Vol. II., p. 683).

VIII.

Reproduction cost new less depreciation.

The existing depreciation in the property was found by the Commission (R. Vol. I., p. 43) and Court (R. Vol. I., p. 197) to be 10 per cent, leaving a reproduction cost new less depreciation of $130,500,000 (R. Vol. I., p. 197), not including working capital or any allowance for going value,—on which latter item the Court accepted,—against the Company's objection and the evidence thereon in the record (R. Vol. II., pp. 709-747),—the allowance of the two Commissions of about 4 per cent (R. Vol. I., p. 196), and agreed with the Company's working capital of $3,000,000, which, therefore, gave a total valuation on the basis of reproduction cost new less depreciation of $137,700,000.

The Commission found the Company's property in 90 per cent condition, *i. e.*, an existing depreciation of 10 per cent. The only witness (R. Vol. II., p. 699) on final hearing on this question was one of the Company's engineers, with thirty years' experience with the Company in construction work, who had made a special inspection of the Chicago property in the winter of 1921 and 1922 and in the summer of 1923, for the purpose of observing its condition. He

stated that he inspected representative portions of the plant to determine existing depreciation, including obsolescence and inadequacy, if any. He found certain paper conduit obsolete, although in use, and gave it only 20 per cent condition (R. Vol. II., pp. 700-701), but found no inadequacy, stating in conclusion that as a result of his familiarity with the property, and his examination thereof, he found that the property was in at least 90 per cent condition.

IX.

Deduction of depreciation reserve.

Although the Commission made the same finding of 90 per cent condition in its order, it also found that the extensions and additions to the Company's property, built out of its depreciation reserve account, should be deducted, because, as the Commission stated, this account had been contributed by the Company's subscribers (R. Vol. I., p. 44). On final hearing the Commission abandoned this theory, as a result of the decision of this Court in *Board of Public Utility Commissioners* v. *New York Telephone Co.*, 271 U. S. 23, and claimed, without any supporting evidence, that the balance in the depreciation reserve represented the existing depreciation of the property, contrary to its previous finding of a 90 per cent condition. No testimony was offered on this question by either the City's or the Commission's experts, but the testimony of the City's expert witness indicated that he did not adopt the Commission's theory of measuring the existing depreciation by the balance in the depreciation reserve (R. Vol. V., p. 1772).

Moreover, the Illinois Commerce Commission, in one of its recent cases in which it did not deduct the balance in the depreciation reserve, or in any manner violate its own accounting rules, clearly and correctly stated the function of the depreciation reserve account, and the distinction

between the bookkeeping entry and the existing depreciation of the property:

> "The record also shows that under present conditions the depreciation reserve is experiencing a healthy growth and is at the present time between 30 and 40 per cent of the book value of the plant. [*The Illinois Company's reserve in 1923 was approximately 30 per cent* (R. Vol. V., p. 1685).] The record shows the plant to be in slightly less than 90 per cent condition indicating that the visible depreciation at present existing in the property is only slightly in excess of 10 per cent while the reserve at present set upon the books of the company is between 30 per cent and 40 per cent thus showing a substantial margin for extraordinary repairs, inadequacy, obsolescence, and any other elements which enter into the computation of a depreciation reserve and must be provided for over and above the visible depreciation as observed by the company's engineer."
>
> *Wabash Valley Telephone Company*, No. 18408 (Company's Exhibit 47-B, R. Vol. IV., p. 1509.)

The decisions of this Court are against the latest contention of the Commission. The exact question raised by the Commission and the City in the present case was disposed of in *McCardle* v. *Indianapolis Water Co.*, 272 U. S. 400, 416, the matter having been fully argued in the briefs; and this Court previously held in *Pacific Gas & Electric Co.* v. *San Francisco*, 265 U. S. 403, 406, that existing depreciation should be determined by inspection. (See also *Standard Oil Co. of N. J.* v. *Southern Pacific Co.*, 268 U. S. 146, 159, where a depreciation estimate based upon a probable average life was disallowed.)

The basis of the argument presented by appellants against the authority of these decisions is that, since the eventual destruction of property by future inadequacy, obsolescence and casualties can be foreseen with enough accuracy to predicate depreciation rates in

part on these causes, there is an actual lessening of value because of such prospective losses. This is unsound, inasmuch as present value is not lessened until such losses are actually realized. Inspection shows any existing inadequacy or obsolescence, or any existing impairment from casualties, but probable future inadequacy, obsolescence or destruction by casualty has no bearing on the present value of any property. Therefore, reserves accrued in part to protect against future loss from these causes have no bearing on present value, any more than the actuarial methods of fire or life insurance companies, and their resulting estimates on the probable future duration of property or length of life, can have any bearing on the present condition of the property or the person. The courts have clearly seen this, and the holdings against the deduction of the balance in the depreciation reserve are almost unanimous.

New York Telephone Co. v. *Prendergast*, 300 Fed. 822 (see however case on final hearing, *New York Telephone Co.* v. *Prendergast*, 36 Fed. (2) 54).

Southern Bell Telephone & Telegraph Co. v. *Railroad Commission of South Carolina*, 5 Fed. (2) 77.

Monroe Gaslight & Fuel Co. v. *Michigan P. U. C.*, 292 Fed. 139.

Garden City v. *Garden City Telephone, Light & Mfg. Co.*, 236 Fed. 693.

Kings County Lighting Co. v. *Prendergast*, 7 Fed. (2) 192, affirmed 272 U. S. 579.

Pacific Telephone & Telegraph Co. v. *Whitcomb*, 12 Fed. (2) 279, affirmed 276 U. S. 97.

As to the tentative order of the Interstate Commerce Commission dated August 15, 1929, relied upon by appellants, it is sufficient to say that the Interstate Commerce Commission, acting under express Congressional direction

to ascertain depreciation rates (see Appendix D, *post*, p. 69), cannot change the pronouncements of the courts relative to a rule of valuation.

The questions raised by the Interstate Commerce Commission will have to be met when properly presented, but are not at issue in the present record.

The Statutory Court very properly points out that the Commission, urging that all elements entering into the expense of depreciation (including prospective but unrealized losses) should be considered as elements for deduction from valuation, could not, at the same time, maintain that the annual expense of depreciation which provided for future losses was too high, and should be arbitrarily reduced. The comments of the Statutory Court on this situation require no elaboration.

The Company contends that the Commission was clearly erroneous in both of its positions, maintains that its depreciation expense was proper in amount, could not be questioned by the State Commission, and that, in any event, it could not be set aside or diminished except on a clear showing that it was wrong, of which there is no evidence; that all the Company's property should be included in its valuation, irrespective of the source of the funds used in its construction; and that the existing depreciation of the property was in the amount found by the Commission and determined by inspection by a competent witness whose testimony thereon was uncontradicted in the record.

X.

Expense of depreciation.

The Illinois Commission had allowed the Company an annual sum "to take care of maintenance and retirement charges" of its property. It did not make a separate finding of the expense of depreciation, but combined it with

maintenance or repair expenses (the latter expenses of the Company being unquestioned in amount), the difference between the Commission's allowance and the actual expense charged by the Company in 1923 for both depreciation and maintenance, amounting to almost $2,000,000 (Company's Exhibit 6, R. Vol. IV., p. 1195). On final hearing, one of the Commission's accountants, showing no knowledge of depreciation rates (R. Vol. V., p. 1854), and disavowing any judgment as to the average life of the Company's property (R. Vol. V., p. 1856), promulgated the Commission's theory in a series of exhibits (Commission's Exhibits 11-13A, R. Vol. I., pp. 233-237), which based the Commission's allowance for maintenance and retirement expense upon the charges made in the Company's accounts annually for property retired from service. When an item of plant is retired for whatever cause, the original cost of that item of plant, minus net salvage, is charged to (deducted from) the depreciation reserve account. It is this charge to the depreciation reserve account of the original cost of an item of plant retired which the Commission called "retirement expense", and upon which it based its justification of the allowance of the expense of depreciation.

The amount of retirement charges is not an expense item, but a capital transaction to remove from the plant accounts property no longer used or useful. In a rapidly growing property such as the Company's, there can be no relation between the capital charges for the retirement of property in any given year, and the expense of depreciation accruing on the property in the same year, for the capital charges for retirement have a relation only to the time when the property was first installed, while the expense of depreciation relates to the greatly enlarged existing property (R. Vol. II., pp. 891-892). The plant being retired has, for all practical purposes, been built in preceding years, but as the plant grows, greater sums are required to be set aside

each year to meet the current expense of depreciation in the larger plant, and so, of course, each year's charge to depreciation expense would have to be larger than the charges to the reserve for retirements. On the average, the plant being charged off the Company's books as retired, is plant which has attained its full age, but in a rapidly growing property there is a great mass of new plant, and the average age of the total property against which charges for the expense of depreciation are being made currently, is much less than the total age of the units which are being retired. The Commission's accountant, of course, had to admit all this when confronted on cross-examination with Company's Exhibit 48 (R. Vol. IV., pp. 1528-1529), which he stated in a general way represents the experience of the Company (R. Vol. V., p. 1858).

The Company's accounting for the expense of depreciation (and all of its accounting) is based upon the accounting rules of the Interstate Commerce Commission (Appendix E, *post*, p. 71; R. Vol. IV., p. 1183), which are the same as those of the Illinois Commission (R. Vol. II., p. 748).

The record shows the proceedings now pending for the determination of depreciation rates by the Interstate Commerce Commission (R. Vol. II., pp. 881-884, 885), including a tentative order of the Commission, and the petitions for rehearing thereon. The Interstate Commerce Commission has ordered the Company, pending final determination, to follow the present accounting rules, which leave to the judgment and experience of the Company the fixing of a depreciation rate for its property, with a provision in the accounting rules that the Company must be prepared at all times to justify under oath the rates being charged (R. Vol. II., pp. 880-884; see Appendix E, *post*, p. 71).

Congress having granted jurisdiction to the Interstate Commerce Commission over the depreciation rates of

telephone companies doing interstate business, by the amendment to Paragraph 5 of Section 20 of the Interstate Commerce Act, approved February 8, 1920 (Appendix D, *post,* p. 69), and the Interstate Commerce Commission having issued an order directing the companies to continue to comply with the Uniform System of Accounts until the further order of the Commission (see Appendix D, *post,* p. 69), it is apparent that Congress has acted upon this particular subject within its Constitutional authority to regulate interstate commerce, and that this subject is now completely withdrawn from the power of the State.

While it is true that the transmission of telephone messages can be, and is, divided into interstate and intra-state transmission, subject to regulation by Congress and State Legislatures, respectively, the telephone property is devoted to both services, and, obviously, two rates of depreciation cannot be charged on the same property.

The regulation of depreciation accounting by the Interstate Commerce Commission is in no way inconsistent with the regulation of intra-state rates for telephone service by State Commissions, the problem of the State Commissions being simplified to the extent of one item of operation, as to which the public interest is safeguarded by the agency of the Interstate Commerce Commission, instead of the State Commissions.

The fact that the Interstate Commerce Commission has not finally acted in the matter does not change the general rule which excludes the jurisdiction of State tribunals. (*Oregon-Washington R. R. & Navigation Co.* v. *State of Washington,* 270 U. S. 87.) State authority is excluded, under the familiar decisions with reference to the Safety Appliance Acts, *Southern Railway Company* v. *Railroad Com'n of Indiana,* 236 U. S. 439; the Hours of Service Act, *Northern Pacific Railroad* v. *Washington, ex rel., Attorney*

General, 222 U. S. 370; and the Federal Employers' Liability Act, *New York Central Railroad Company* v. *Winfield,* 244 U. S. 147; and the same principles, of course, apply to matters committed by Congress to the Interstate Commerce Commission, and subject to its rules: *Pennsylvania Railroad Company* v. *Public Service Commission,* 250 U. S. 566; *Postal Telegraph-Cable Co.* v. *Warren-Godwin Lumber Company,* 251 U. S. 27.

The expense of depreciation of the Company was determined under the order of the Interstate Commerce Commission requiring the Company's officers to fix a depreciation rate from the Company's history and experience, and the judgment of the Company's officers in fixing depreciation rates for the different classes of property [resulting in a composite rate in 1923 of 4.926 per cent (R. Vol. II., p. 886)], must be upheld by the Court, both as a matter of law and on the evidence in the record.

XI.

Present fair value.

With these findings of value, *i. e.,* reproduction cost new, $145,000,000; working capital, $3,000,000; and going value, at least $4,200,000, the Court adopted, for the purpose of its computations, as a minimum value as of June 30, 1923, $125,000,000, deducting 10 per cent for depreciation (R. Vol. I., pp. 197-198).

On the record before it, the Court could very properly have found a present value of $130,500,000 reproduction cost new less depreciation, $3,000,000 working capital, and $14,500,000 going value (10 per cent of reproduction cost new), or a total of $148,000,000. The Company had no basis for an appeal to this Court,

if one were desired, since only a minimum value was found by the Statutory Court, which specifically stated, "We are not to be understood as * * * holding that the evidence does not warrant a higher valuation than $125,000,000".

The Commission found a present fair value as of December 31, 1922, of $96,000,000, or, with net additions of $9,938,198 added to June 30, 1923, of, say, $106,000,000. We cannot understand the statements on valuation made by the appellants, and believe them, and many other portions of the Appellants' Brief and Argument, inaccurate, incomplete and unreliable.*

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*Appellants' discussion of valuation is based largely upon a comparison of percentages of various findings of reproduction cost with finding of valuation and "book cost". Not only do they err in comparing the incomparable [Appellants' brief, p. 301] (book cost without the addition of omitted overheads, with reproduction cost containing all overheads; value containing going value, materials and supplies, etc., with reproduction cost not containing these elements), but entirely misstate some findings. (The correct Commission findings are found in R. Vol. I., pp. 43-44; the Court findings on value being in R. Vol. I., pp. 197-198.)

The most serious misstatement is that of the Commission's valuation in the tables on page 301 of the appellants' brief: there they state the Commission's valuation as of December 31, 1922, to be $110,553,128, whereas the finding actually was $96,000,000 (R. Vol. I., p. 44), including physical property, overheads, working capital, going value and work in progress; similarly, the statement of the Commission's valuation as of June 30, 1923, of $120,491,326 (which is only their statement of the December 31, 1922 finding, plus net additions), is exaggerated by the excess over approximately $106,000,000 (the Commission's actual finding of $96,000,000, plus net additions).

It is also stated that the Statutory Court found value as of December 31, 1922, of $120,767,426, and as of June 30, 1923, of $130,705,624 (Appellants' Brief, p. 301). There is no basis to explain these figures. The Court found a minimum value as of June 30, 1923, of $125,000,000,

XII.

Rate of return.

No comment would be required as to the rate of return resulting to the Company from the proposed decreased rates, under the assumptions made by the Statutory Court most favorable to the appellants, were it not for the assertion of appellants that it would be due process of law to fix a lower rate of return to a licensee company of the Bell System than to other telephone companies not so licensed. This argument, however, assumes, contrary to the fact, that the Illinois Company and the American Company are one in point of law; and that the reduced operating expenses of, and the financial advantages to, the Illinois Company, resulting from the License Contract with the American Company and the supply contract with the Western Electric Company, should also be considered as reducing the rate of return to which the Illinois Company is entitled as a matter of law in determining the issue of confiscation.

A fair return to the Bell System is not a legal conception, and neither the cost of money to the American Company, nor its earnings on the properties shown in its consolidated earning statement, are material to the issues presented in the present proceeding. Nor can the fact that the Illinois Company has operated its Chicago exchange for a period of ten years under the minimum rates fixed in 1920 by the predecessor of the present Illinois Commission, militate in any manner against the Company's constitutional right to

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presumably including all elements of value (R. Vol. I., p. 197). The Court's finding of reproduction cost new less depreciation was $130,500,000, excluding working capital and going value (R. Vol. I., p. 197).

(See also Footnotes, p. 42 and p. 46, *ante*.)

protect its property from confiscation under the enjoined order.

In its enjoined order, the Illinois Commission allowed a 7½ per cent return, and the evidence in the record indicates that any return below 8 per cent would be confiscatory (R. Vol. II., pp. 872, 869-879).

CONCLUSION

The Statutory Court has commented on the cause of the delay in the final hearing of this case, and the failure of the Commission to act during the intervening period. All the findings of the Statutory Court are sustained by competent evidence in the record, its statements of law are correct, the questions at issue are determined by previous decisions of this Court, and the final decree should be affirmed.

Respectfully submitted,

CHARLES M. BRACELEN,
HORACE KENT TENNEY,
WILLIAM DEAN BANGS,
Solicitors for Illinois Bell Telephone Company.

October 11, 1930.

APPENDIX A

Court and Commission Decisions Approving License Contract Between American Telephone and Telegraph Company and Its Licensee Companies After Investigation.

Federal Courts

Name of Court	*Style of Case*	*Citation*
United States Supreme Court	*City of Houston v. Southwestern Bell Tel. Co.	259 U. S. 318
United States Supreme Court	State of Missouri, ex rel., Southwestern Bell Tel. Co. v. Missouri Public Service Commission	262 U. S. 276
United States District Court—District of Indiana	Indiana Bell Tel. Co. v. Public Service Commission of Indiana	300 Fed. 190
United States District Court—District of Nebraska	*Northwestern Bell Tel. Co. v. Spillman, Atty. Gen'l, et al.	6 Fed. (2) 663
United States District Court—District of Maryland	Chesapeake & Potomac Tel. Co. of Baltimore City v. Ezra B. Whitman, et al., Commissioners	3 Fed. (2) 938
United States District Court—Southern District of New York	*New York Tel. Co. v. Prendergast, et al.	36 Fed. (2) 54
United States District Court—Eastern District of South Carolina	*Southern Bell Tel. & Tel. Co. v. Railroad Commission of South Carolina	5 Fed. (2) 77
United States District Court—Western District of Washington (Southern Division)	*Pacific Tel. & Tel. Co. v. Whitcomb and Home Tel. & Tel. Co. of Spokane v. Denney	12 Fed. (2) 279 (affirmed 276 U. S. 97.)

*In these cases, special masters filed reports approving the License Contract.

State Courts

Name of Court	*Style of Case*	*Citation*
Kansas Supreme Court	Southwestern Bell Tel. Co. v. Public Utilities Commission	223 Pac. 771
Michigan Supreme Court	City of Detroit v. Michigan Railroad Commission	117 N.W. 306
Michigan Supreme Court	Michigan Public Utilities Commission v. Michigan State Tel. Co.	228 Mich. 658
Ohio Supreme Court	City of Cleveland v. Public Utilities Commission	131 N.E. 714

Commission Decisions

State Commission	*Style of Case*	*Citation*
Alabama	City of Birmingham v. Southern Bell Tel. & Tel. Co.	P.U.R. 1919B, 791
Arizona	*In re* Investigation on its own initiative of rates, etc.	P.U.R. 1920B, 411
Arkansas	In the Matter of the Southwestern Bell Tel. Co. (Fort Smith)	P.U.R. 1921B, 516
Colorado	*In re* Mountain States Tel. & Tel. Co.	P.U.R. 1917B, 198
District of Columbia	In the Matter of the Petition of the Federation of Citizens' Associations for a reduction of rates, etc.	P.U.R. 1924D, 152
Idaho	*In re* Application of the Mountain States Tel. & Tel. Co.	P.U.R. 1921B, 739
Illinois	In the Matter of the application of the Chicago Tel. Co.	P.U.R. 1921C, 287 111 Commission Leaflet 93

State Commission	Style of Case	Citation
Louisiana	*Ex parte* Cumberland Tel. & Tel. Co.	P. U. R. 1921C, 330
	Ex parte Cumberland Tel. & Tel. Co. (Rehearing)	P. U. R. 1921C, 363
Maine	*In re* New England Tel. & Tel. Co.	P. U. R. 1926B, 247
Maryland	*In re* Chesapeake & Potomac Tel. Co.	P. U. R. 1916C, 925
Massachusetts	*In re* Investigation by the Department of Public Utilities.	P. U. R. 1925E, 739
Michigan	*In re* Application of Michigan State Tel. Co. (Detroit)	P. U. R. 1918C, 81
	In re Application of Michigan State Tel. Co.	P. U. R. 1921C, 545
Montana	Public Service Commission of Montana v. The Mountain States Tel. & Tel. Co.	P. U. R. 1924C, 545
Nebraska	*In re* Lincoln Tel. & Tel. Co. (Beatrice)	P. U. R. 1929E, 512
New Hampshire	*In re* New England Tel. & Tel. Co.	P. U. R. 1926E, 186
New Jersey	*In re* Rates of New York Tel. Co.	P. U. R. 1918B, 999 73 Commission Leaflet 83
New Mexico	In the Matter of the Schedule of Rates, etc., of The Mountain States Tel. & Tel. Co.	P. U. R. 1923B, 352
Pennsylvania	*In re* Uniform Telephone Rates	P. U. R. 1917D, 259
Rhode Island	Public Utilities Com. v. New England Tel. & Tel. Co.	P. U. R. 1926C, 207

State Commission	*Style of Case*	*Citation*
South Carolina	*In re* Southern Bell Tel. & Tel. Co.	P. U. R. 1921D, 53
Vermont	*In re* Increase of Rates of New England Tel. & Tel. Co.	P. U. R. 1927C, 34
Washington	Public Service Commission v. Pacific Tel. & Tel. Co.	P. U. R. 1919F, 13
West Virginia	*In re* Chesapeake & Potomac Tel. Co. of West Virginia	P. U. R. 1925C, 57
Wisconsin	Bogart v. Wisconsin Tel. Co. (Milwaukee)	P. U. R. 1916C,102

APPENDIX B

Court and Commission Decisions Approving Supply Contract Between Licensee Companies of American Telephone and Telegraph Company and Western Electric Company, Inc.

Federal Courts

Name of Court	*Style of Case*	*Citation*
United States Supreme Court	*City of Houston v. Southwestern Bell Tel. Co.	259 U.S. 318
United States District Court—Eastern District of South Carolina	*Southern Bell Tel. & Tel. Co. v. Railroad Commission of South Carolina	5 Fed. (2) 77
United States District Court—District of Nebraska	*Northwestern Bell Tel. Co. v. Spillman, Atty. Gen'l, et al.	6 Fed. (2) 663
United States District Court—Southern District of New York	*New York Telephone Co. v. Prendergast, et al.	36 Fed. (2) 54

State Courts

Name of Court	*Style of Case*	*Citation*
Kansas Supreme Court	Southwestern Bell Tel. Co. v. Public Utilities Commission	223 Pac. 771

*In these cases, special masters filed reports approving the supply contract.

Commission Decisions

State Commission	*Style of Case*	*Citation*
Arizona	*In re* Investigation by Commission of Rates, etc.	P. U. R. 1920B, 411
	In re Mountain States Tel. & Tel. Co. (Phoenix)	207 Commission Leaflet 195
Colorado	*In re* Mountain States Tel. & Tel. Co.	P. U. R. 1917B, 198
District of Columbia	In the Matter of Rates of the Chesapeake & Potomac Tel. Co.	P. U. R. 1922E, 652
Georgia	*In re* Application of Southern Bell Tel. & Tel. Co.	P. U. R. 1921C, 833
Idaho	*In re* Application of Mountain States Tel. & Tel. Co.	P. U. R. 1921B, 739
Indiana	*In re* Petition of Indiana Bell Tel. Co. (Indianapolis)	P. U. R. 1922C, 348
Louisiana	*Ex parte* Cumberland Tel. & Tel. Co.	P. U. R. 1921C, 363
Maine	*In re* New England Tel. & Tel. Co.	P. U. R. 1926B, 247
Maryland	*In re* Application of the Chesapeake & Potomac Tel. Co.	P. U. R. 1920F, 417
Massachusetts	*In* re Investigation by the Department of Public Utilities.	P. U. R. 1925E, 739
Michigan	City of Detroit v. Michigan Railroad Commission	77 Commission Leaflet 1087
Montana	Public Service Commission of Montana v. The Mountain States Tel. & Tel. Co.	P. U. R. 1924C, 545
Nebraska	In the Matter of the Application of the Northwestern Bell Tel. Co.	P. U. R. 1923B, 112

State Commission	*Style of Case*	*Citation*
New Hampshire	*In re* New England Tel. & Tel. Co.	P. U. R. 1926E, 186
New Mexico	In the Matter of the Schedule of Tolls, etc., of the Mountain States Tel. & Tel. Co.	P. U. R. 1923B, 352
New York	In the Matter of the Hearing, etc., as to Rates, Charges and Rentals of the New York Tel. Co.	P. U. R. 1923B, 545
	In the Matter of the Complaint of the New York Tel. Co. against Maximum Rates, etc.	P. U. R. 1926E, 1
Oregon	*In re* Application of the Pacific Tel. & Tel. Co.	P. U. R. 1921D, 530
Rhode Island	Public Utilities Commission v. New England Tel. & Tel. Co.	P. U. R. 1926C, 207
Utah	*In re* Application of the Mountain States Tel. & Tel. Co.	P. U. R. 1921E, 117
Vermont	*In re* Increase of Rates New England Tel. & Tel. Co.	P. U. R. 1927C, 348
Virginia	*In re* Application of the Chesapeake & Potomac Tel. Co.	P. U. R. 1920F, 49
West Virginia	*In re* Chesapeake & Potomac Tel. Co.	P. U. R. 1921B, 97
Wisconsin	Bogart v. Wisconsin Tel. Co.	P. U. R. 1916C, 1020

APPENDIX C

Commission Orders Approving the Board-to-Board Basis of Toll Separation

State Commission	*Style of Case*	*Citation*
Georgia	Re Hawkinsville Telephone Co.	138 Commission Leaflet 1112, 1115
Indiana	Re Indiana Bell Telephone Co.	P. U. R. 1922E, 46, 78
Missouri	Re Southwestern Bell Telephone Co.	162 Commission Leaflet 367, 376
Nebraska	Re Tri-County Telephone Co. v. Gandy Switchboard Co.	P. U. R. 1920B, 760, 765
	Re Northwestern Bell Telephone Co.	P. U. R. 1923B, 112, 170
New York	Stone v. New York Telephone Co.	P. U. R. 1921D, 736, 751
North Dakota	Railroad Commission v. Abercrombie Telephone Co.	P. U. R. 1923E, 467, 472
Rhode Island	Public Utilities Commission v. New England Telephone & Telegraph Co.	P. U. R. 1926C, 207, 261
Wisconsin	Re Rock County Farmers Telephone Co.	P. U. R. 1925A, 178, 180
	Application of Wisconsin Telephone Co. (DePere Exchange)	160 Commission Leaflet 1272, 1280

APPENDIX D

INTERSTATE COMMERCE COMMISSION
WASHINGTON.

March 18, 1920.

TO ALL CARRIERS CONCERNED:

Section 435 of the Transportation Act, 1920, contains the following provision:

> "The Commission shall, as soon as practicable, prescribe, for carriers subject to this Act, the classes of property for which depreciation charges may properly be included under operating expenses, and the percentages of depreciation which shall be charged with respect to each of such classes of property, classifying the carriers as it may deem proper for this purpose. The Commission may, when it deems necessary, modify the classes and percentages so prescribed. The carriers subject to this Act shall not charge to operating expenses any depreciation charges on classes of property other than those prescribed by the Commission, or charge with respect to any class of property a percentage of depreciation other than that prescribed therefor by the Commission. No such carrier shall in any case include in any form under its operating or other expenses any depreciation or other charge or expenditure included elsewhere as a depreciation charge or otherwise under its operating or other expenses." [Sec. 20 ¶ (5) of Interstate Commerce Act, 41 Stat. 493.]

Information received by the Commission indicates the existence of doubt as to the propriety of carriers making any charges to operating expenses with respect to depreciation prior to such time as the Commission shall prescribe the specific percentages of depreciation which shall be charged.

The purpose of this circular is to dispel any such doubt as may exist in the minds of accounting officers.

Until the Commission shall otherwise order, all carriers subject to the Act to regulate commerce should continue to observe the requirements respecting the accounting for depreciation which are embodied in the effective accounting classifications prescribed by the Commission for the respective classes of carriers.

GEORGE B. MCGINTY,
Secretary.

(Appellee's Exhibit 18, R. Vol. IV., p. 1279.)

APPENDIX E

The accounting rules of the Interstate Commerce Commission are in the record (Company's Exhibit 3, R. Vol. IV., pp. 1183, *et seq.*), and the pertinent provisions thereof as to depreciation accounting are as follows (R. Vol. IV., pp. 1190-1191):

"23. *Depreciation of plant and equipment.*—Telephone companies should include in operating expenses depreciation charges for the purpose of creating proper and adequate reserves to cover the expenses of depreciation currently accruing in the tangible fixed capital. By *expense of depreciation* is meant—

(a) The losses suffered through the current lessening in value of tangible property from wear and tear (not covered by current repairs).

(b) Obsolescence or inadequacy resulting from age, physical change, or supersession by reason of new inventions and discoveries, changes in popular demand, or public requirements, and

(c) Losses suffered through destruction of property by extraordinary casualties.

The amount charged as expense of depreciation should be based upon rules determined by the accounting company. Such rules may be derived from a consideration of the company's history and experience. Companies should be prepared to furnish the Commission, upon demand, the rules and a sworn statement of the facts, expert opinions, and estimates upon which they are based. * * *

"The rate of depreciation should be fixed so as to distribute, as nearly as may be, evenly throughout the life of the depreciating property the burden of repairs and the cost of capital consumed in operations during a given month or year, and should be based upon the

average life of the units comprised in the respective classes of property.

"The amount estimated to cover the expense of depreciation of fixed capital should be charged monthly to account No. 608, 'Depreciation of Plant and Equipment' (or to the appropriate clearing account or accounts), and concurrently credited to Account No. 102, 'Reserve for Accrued Depreciation—Cr.'"

The provisions of the accounting, rules of the Illinois Commerce Commission are identical (R. Vol. II., p. 748).